



Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Interpretive Letter #1020

February 8, 2005

March 2005

12 USC 72

**Re: [] National Bank, [City, State]
Opinion Request on Trust Preferred Stock Qualifying as Directors'
Qualifying Shares**

Dear []:

This letter responds to your inquiry about whether national bank directors may purchase trust preferred stock (“TPS”) to meet the requirement that they own directors’ qualifying shares under 12 U.S.C. § 72. Based on the specifics of your proposal, as described herein, we believe the TPS will qualify as directors’ qualifying shares.

[] National Bank, [City, State] (the “Bank”) is seeking to add directors to its board. Under your proposal, the bank holding company for the Bank (the “Holding Company”) will form [] (the “LLC”) and purchase all of the LLC’s common membership units. The LLC will issue trust preferred stock (“TPS”) to the new Bank directors in exchange for \$3,000,000 in cash. The LLC will then use the \$3,000,000 to purchase \$3,000,000 in junior subordinated debentures from the Holding Company, which will be the sole asset of the LLC. The junior subordinated debentures will have a fixed maturity of at least 30 years, and will be subordinated to all other debts of the Holding Company and superior only to the Holding Company’s preferred and common stock. The new directors will treat the TPS as qualifying shares under 12 U.S.C. § 72. This transaction is structured so the TPS qualifies as tier 1 capital for the Holding Company.

Twelve U.S.C. § 72 generally requires that “[e]very director must own...capital stock of the association of which he or she is a director the aggregate par value of which is not less than \$1,000, or an equivalent interest, as determined by the Comptroller of the Currency, in any company which has control over such association [as determined by the Bank Holding Company]

Act].” The purpose of the statute is to ensure that a national bank director has a financial stake in the operations of the bank (or its parent company) so that the director will have the incentive to be vigilant in protecting the bank’s interests.¹

Twelve C.F.R. § 7.2005 generally provides that (i) a national bank director must own a qualifying equity interest of common or preferred stock with a value of \$1,000 in the national bank or in a company that controls the national bank; and (ii) the OCC may consider whether other interests in a company controlling a national bank constitute an interest equivalent to \$1,000 par value of national bank stock.

The OCC has found that a variety of different holdings can provide a national bank director with an “equivalent interest” that satisfies the qualifying share requirement of 12 U.S.C. § 72. For example, the OCC has permitted directors to invest in a bank’s preferred stock to meet the qualifying shares requirement.² In one instance, the OCC excused a director from owning any stock where the bank was able to structure an arrangement effectively giving the director the same type of incentives as is contemplated under 12 U.S.C. § 72.^{3,4}

The overriding principle the OCC has consistently applied to its interpretations of 12 U.S.C. § 72 has been that the interest must assure that bank directors have a financial stake in the operations of the bank, evidenced by an equity or an equivalent interest. An “equivalent interest” includes a financial interest in a bank or holding company that creates incentives similar to stock ownership for directors to be vigilant in overseeing the bank’s operations.

The proposed TPS investments have characteristics similar to equity holdings and create comparable incentives for bank directors to be vigilant. TPS has a long life approaching economic perpetuity since investors are repaid from income on a 30-year subordinated

¹ See OCC Interpretive Letter No. 83 (May 29, 1979), citing *Cupo v. Community National Bank and Trust Company*, 324 F. Supp. 1390 (E.D.N.Y. 1971); see also OCC unpublished letter from Peter Liebesman, Assistant Director, Legal Advisory Services Division dated May 29, 1985, and unpublished from Christopher Manthey, Senior Attorney, Legal Advisory Services Division letter dated September 5, 1989. Qualifying shares must constitute both legal and beneficial interests. OCC Interpretive Letter No. 83 (May 29, 1979), citing *Transamerica Corporation v. Parrington*, 115 Cal.App.2d 346, 252 P.2d 388 (1953).

² Unpublished letter from Emory W. Rushton, Deputy Comptroller for Multinational Banking, dated April 11, 1988. (“Although it may have preferences as to dividends, voting or liquidation rights, bank preferred shares, like common shares, represent an equity interest in the bank sufficient to induce the holder ‘to be vigilant in protecting the banks interests,’ ” quoting *Cupo, supra*.)

³ Unpublished letter from Michael J. Linowes, Attorney, dated November 21, 1994. The situation involved a nun who had taken a vow of poverty and was prohibited for religious purposes from meeting the ownership requirement. The OCC found the qualifying share requirement was met where a charitable organization for which the nun served as a member of the board owned stock in the bank and the nun had the exclusive right to vote the stock.

⁴ While one older OCC staff letter found that a subordinated debenture was not comparable to an equity interest in a bank and did not qualify as an “equivalent interest” under Section 72, letter dated May 29, 1985 from Peter Liebesman, Assistant Director, Legal Advisory Services Division, Section 72 does not require the holding to be an equity interest, only an “equivalent interest.” Moreover, the letter does not reflect the OCC’s current views, described in more recent precedents permitting non-equity interests that provide similar incentives. See unpublished letter from Michael J. Linowes, Attorney, dated November 21, 1994.

debenture. TPS holders also have considerable risk of loss of dividends if the Bank performs poorly since dividends may be deferred up to 20 consecutive quarters to provide financial support to troubled subsidiaries. Moreover, TPS investors hold a position that is subordinate to all obligations of the Holding Company, other than common and preferred shareholders. Due to their deeply subordinate position, directors owning TPS have substantial risk of loss if their oversight results in the Bank’s failure.⁵ Altogether, the long life, potential dividend deferral and a substantially subordinate position of TPS create incentives similar to equity holdings for directors to assure the financial success of the bank.

The treatment of TPS for capital purposes by the Federal Reserve Board (the “FRB”) further supports the view that TPS is an “equivalent interest” for purposes of § 72 because the FRB treats TPS for capital purposes similarly to the way it treats other risk capital (e.g., preferred and common stock). The FRB permits the TPS to qualify for inclusion in the Holding Company’s tier 1 capital.⁶ Treating TPS as tier 1 capital is consistent with the notion that TPS represents funds that are put “at risk” in the bank, giving the holders (*i.e.*, directors) a financial stake tied to the success or failure of the enterprise. In fact, the FRB’s recent proposed rule on the treatment of TPS as tier 1 capital is based in large part on the features of TPS that make it an investment tied to the performance of the bank. These features include having a long life that approaches economic perpetuity, permitting the issuer to defer dividends, and being deeply subordinated.⁷ The proposed TPS holdings meet these criteria, as noted in the preceding paragraph.

While the TPS holdings are issued by the LLC, they represent a financial “interest” in the Holding Company. The sole asset of the LCC is the junior subordinated debenture issued by the Holding Company. As a result, the LLC will be solely and completely dependent on the ability of the Holding Company to pay interest and principal on the junior subordinated debentures in order for the LLC to pay dividends and a return of capital on the TPS. TPS is effectively an investment in the Holding Company and certainly an interest in the Holding Company for purposes of Section 72.

Accordingly, based on the foregoing, we believe the TPS will qualify as directors’ qualifying

⁵ While directors holding the TPS are paid prior to equity holders, their position is so subordinate that they have similar incentives to act affirmatively to maintain the financial health of the bank.

⁶ FRB Press Release, October 21, 1996. Although there have been recent changes in the treatment of TPS for financial accounting purposes, the FRB under a recent proposal will continue to treat TPS as tier 1 capital of bank holding companies, subject to certain new quantitative limitations. 69 Fed. Reg. 28851, *et seq.* (May 19, 2004).

⁷ 69 Fed. Reg. 28851 at 28852.

shares. If you have any questions on the foregoing, or need any additional information, please feel free to contact Eugene H. Cantor, Counsel, Securities & Corporate Practices Division, at 202-874-5202.

Sincerely,

/s/ Daniel P. Stipano

Daniel P. Stipano
Acting Chief Counsel